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Future Financing Needs of the Highly Indebted Countries

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and
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What amount of external resources would be required to reverse recent investment trends and bring about modest growth in per capita incomes? Between $18 and $20 billion of net new disbursements annually. But consider the alternatives....

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Under base scenario assumptions, the authors estimate that the Baker 17 countries will require about $18 to $20 billion of net new disbursements annually to reverse recent investment trends and bring about modest growth in per capita incomes.

The most significant shortfall is in commercial bank lending. Without an adequate burden-sharing arrangement, it is unlikely that official creditors — particularly the multilateral institutions — would be prepared to assume a disproportionately large exposure risk in these countries.

Husain and Mitra conclude that with sound adjustment policies in the debtor countries, a combination of concerted new lending, debt reduction, reflows of flight capital, and intermittant accumulation of interest arrears will be the principal means of financing.

Some countries — such as Mexico, Venezuela, Nigeria, and Ecuador — need external financing to offset their worsening terms of trade. Others need it to restore productive investment to reasonable levels.

At least some countries should be able to work their way out of the debt crisis, as their needs are feasible, so commercial bank creditors will probably respond favorably. Others will have to balance the finance from official and private creditors.

Others will be unable — even under the most stringent conditions and policies — to grow out of their present difficulties without some reduction in the stock or servicing of their debt.

The lumping together of good and bad debtors is repulsing efforts of countries that should have access to voluntary lending. The main actors should begin by abandoning the concept of a homogeneous group of 15 or 17 highly indebted countries (HICs). The contagion effect should not deter the creditors from differentiating between countries on the same continent that have managed their economies well and are close to creditworthiness from those whose economic policies and management are of questionable quality.

The next logical step is to develop a cooperative framework that channels money through equitable burden sharing and promotes credit enhancement, debt reduction, and other innovative financing techniques in support of growth-oriented adjustment programs.

The alternative is continued stagnation in the highly indebted countries — which could mean political and social unrest, a greater reluctance to maintain orderly debtor-creditor relationships, and a disruption of debt servicing even in countries that have carried out their obligations unfailingly.

This paper, prepared for the conference "Dealing with the Debt Crisis," is a product of the Debt and International Finance Division, International Economics Department Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Sheilah King-Watson, room S8-029, extension 33730 (34 pages with tables).

Future Financing Needs of the Highly Indebted Countries

by
Ishrat Husain
and
Saumya Mitra

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The external financing prospects of 17 highly indebted countries for 1989-95 fall considerably short of the requirements if a steady rate of growth is to be achieved. The most significant shortfall is in commercial bank lending. Without adequate burden sharing, it is unlikely that official creditors, particularly the multilateral institutions, will assume a disproportionately large exposure in these countries. With sound adjustment policies in the debtor countries, a combination of concerted lending, debt reduction, reflows of flight capital, and some intermittant accumulation of interest arrears will be the principal means of financing.

Some countries--such as Mexico, Venezuela, Nigeria, and Ecuador--need external finance to offset their worsening terms of trade; others need it to restore productive investment at reasonable levels. At least some countries should be able to work their way out of the debt crisis--because their resource requirements are feasible and commercial bank creditors will probably respond favorably. Others will have to balance the finance from official and private creditors. Others still will be unable, even under the most stringent conditions and most sensible policies, to grow out of their difficulties without some reduction in the stock or servicing of their debt.

The lumping together of good and bad debtors is repulsing efforts of countries that should have access to voluntary lending. The main actors should begin by abandoning the concept of a homogeneous group of 15 or 17

highly indebted countries. The contagion effect should not deter the creditors from differentiating between countries in the same continent that have managed their economies well and are close to creditworthiness from those whose economic policies and management are of questionable quality. The next logical step is to develop a cooperative framework that channels money through equitable burden sharing and promotes credit enhancement, debt reduction, and other innovative financing techniques in support of growth-oriented adjustment programs. The alternative is continued stagnation in the highly indebted countries--which could mean political and social unrest, a greater reluctance to maintain orderly debtor-creditor relations, and a disruption of debt servicing even in countries that have carried out their obligations unfailingly.

The Record

The net flows to highly indebted countries declined precipitiously from an annual average of $41 billion during 1980-82 to about $8 billion a year during 1986-88 (table 1). 1/ In the earlier years, private lending provided three-fourths of resources to these countries. In the recent years, official lending and transfers account for the bulk of the resources. The picture becomes bleaker if net transfers are examined. From an aggregate net annual transfer of $16 billion in 1980-82, net transfers started to turn negative in 1982 and accelerated to an average outflow of about $29 billion a

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1/ Aggregate net flows consist of net disbursements of official transfers, direct and equity investment, short-, medium-, and long-term loans from all sources to the private and public sectors in a country. Net flows, as defined in the World Debt Tables and elsewhere, consist only of net disbursements of short-, medium-, and long-term loans and exclude other components of resource flows.

year in the last three years. 2/

Table 1:

Highly Indebted Countries
Aggregate Net Resource Flows 1980-88
($ billion)

	1980-82 (annual average)	1983-85 (annual average)	1986-88 (annual average)
Official transfers	0.4	0.8	1.4
Private Direct Investment	4.0	3.5	2.5
Official lending (net)	6.7	8.2	4.4
Bilateral	2.2	1.6	1.6
Multilateral	3.1	3.8	3.9
IMF	1.4	3.8	-1.1
Private lending (net)	30.1	7.3	-0.5
Aggregate net flows	41.2	19.8	7.8
Memo Item			
Aggregate Net Transfers	15.9	-20.8	-29.0

Sources: World Bank, OECD and IMF.

Because commercial banks accounted for most of the external financing to highly indebted countries, the dramatic decline in their net flows from $24 billion in 1982 to -$1.0 billion in 1988 is quite revealing (table 2). In 1982 net lending by these banks financed almost 100 percent of interest payments due to them. By 1988 internally generated resources of highly indebted countries financed 100 percent of interest payments and even a small fraction of amortization. During the same period, the domestic savings rate

2/ Aggregate net transfers are defined as aggregate net flows minus interest payments. This concept differs from net transfers that is used in the World Debt Tables and elsewhere in so far as it covers both debt-creating as well as nondebt-creating flows.

of these 17 countries remained almost unchanged at around 21 percent of GDP, showing that domestic savings were financing both domestic investment and external outflows.

Table 2:

Highly Indebted Countries
Net Lending by Commercial Banks 1/
($ billion)

	1982	1985	1986	1987	1988
Disbursements	48.8	13.5	10.5	10.6	11.7
Principal Repayments	21.0	12.3	12.6	10.0	12.6
Net lending	27.8	1.2	-2.1	0.6	-0.9
Interest payments	27.5	27.9	25.6	21.3	28.9
Net lending as % of Interest payments	101.1%	4.3%	-8.2%	2.8%	-3.1%

1/ Public and Publicly Guaranteed (PPG) Financial Markets plus Private Non-Guaranteed (PNG).

Source: World Debt Tables, 1988, The World Bank.

Multilateral institutions are still the major source of positive net flows, but the volume has shrunk considerably due to repayments of large borrowings from the IMF during 1982-85 (table 3) as the Fund's resources are revolving and for temporary support only. The World Bank has stepped up its adjustment lending, and in 1985-88 it was about the only identifiable source of net new funds to these countries, with average net disbursements of $2.9 billion annually. Net lending by multilateral institutions accounted for about 29 percent of interest payments in 1988, much lower than the 326 percent in 1982.

Table 3:

Highly Indebted Countries
Net Lending by Multilateral Institutions /a
($ billion)

	1982	1985	1986	1987	1988
Disbursements	7.7	8.9	10.7	10.2	10.8
Principal Repayments	1.5	3.3	5.9	8.2	9.2
Net lending	6.2	5.6	4.8	2.0	1.6
Interest payments	1.9	3.7	4.8	5.6	5.5
Net lending as % of Interest payments	326%	151%	100%	35.7%	29.1%

/a PPG Multilateral debt including Use of IMF Credit.

Source: World Debt Tables, 1988, The World Bank.

As the debt indicators show, most highly indebted countries are no better placed than when the debt crisis erupted six years ago--signaling the need to depart from the present approach. The stock of outstanding debt grew one-third during this period, and the debt-GNP ratio and debt-export ratio have almost doubled (table 4). Total debt servicing, despite repeated reschedulings, accounted for 43 percent of their exports in 1988, up from 37 percent in 1982. The interest to export ratio has eased only marginally and only because of rising arrears. The ratio of interest payments to exports in 1988 was still as high as 26 percent, despite the highly indebted countries' expansion of export volumes by almost 3 percent a year for the last six years. So, despite net resource transfers of 3 to 4 percent of their GDP to creditors--by compressing imports and generating a trade surplus--the highly indebted countries could not reduce their debt ratios, and they have paid a heavy price in forgone economic growth.

Table 4:

Highly Indebted Countries
Debt Indicators

	1980	1982	1985	1986	1987	1988
1. Total External Debt (US$ b)	289	391	454	482	527	512
2. Debt-GNP ratio	33	45	59	62	63	61
3. Debt-export ratio	171	259	296	353	357	321
4. Debt-service ratio /a	26	37	39	36	36	43
5. Interest-export ratio /a	12	20	26	27	19	26

/a These ratios differ from those reported in the World Debt Tables as they include private non-guaranteed debt, short-term debt and IMF charges.

Source: Author calculations.

To sum up, the last six years for the highly indebted countries have not been favorable. Per capita incomes and real wages have declined, inflationary pressures have intensified, net investment rates are abysmally low, the debt burden has risen, and external financing flows have turned negative. This setting augurs poorly for a speedy, sustained recovery by these countries in the near future. The rest of this paper examines the external financing needs of these 17 countries for the next six years. How much do they need to resume modest growth in their per capita incomes? And what are the prospects for, and constraints on, this financing?

External Financing Needs

Two scenarios underlie the estimates here of the highly indebted countries' external financing requirements through 1995. The scenarios differ in the assumptions about the GDP growth of the highly indebted countries' trading partners and about developments in interest rates and the terms of trade. The effect of a slowdown in industrial countries' growth in 1989-90 and higher real interest rates on the external financing requirement is

discussed, but no effort is made to trace the effects of a lesser adjustment effort by the highly indebted countries. (The underlying assumption is that the countries that are not prepared to undertake strong adjustment efforts are not eligible for external financing support). This scenario may seem to err on the pessimistic side, but it is intended to provide a possibly higher bound measure of the external financing needed to support growth in a "stagflationary" environment similar to that of 1979-82. The GDP growth rate of the highly indebted countries is projected at 4.5 percent for 1988-95--ranging from 5.5 percent for Brazil and the Philippines to 2 percent for Yugoslavia.

The Base Scenario

The projections under the base scenario have three assumptions: (1) continued annual growth in the GDP of the highly indebted countries' trading partners of 2.5 to 3 percent to 1995, enabling annual increases in the highly indebted countries' export volumes of about 5 percent; (2) some recovery in the terms of trade from the historic lows of 1986 and 1987; and (3) nominal LIBORs of 8.5 percent until 1991, then gradually falling to 7 percent in 1995. The aggregate projections are comprised of individual countries (given the common external environment for growth, prices, and interest rates) that utilize the IBRD's Revised Minimum Standard Model (RMSM). This model contains a close relationship between the rate of investment within an economy and the rate of growth of output. This simple specification permits the use of this approach across countries. It is widely familiar to individual country economists and is the central tool in formulating projections in the World

Bank. It has the disadvantage of failing to capture other (important) elements that influence growth, but it is judged that for medium-term analysis the robustness is sufficiently great to project financing requirements required to support growth. Once the investment requirements are identified (through incremental capital-output ratios) and the domestic savings performance are specified, the external financing requirement is obtained as a residual. In most cases an improvement in the domestic marginal savings effort has been postulated (presumed to occur because of policy improvements as adjustment programs proceed); this helps to avoid a possible overstatement of the external financing requirement. The country projections also hinge on a fiscal policy correction to realize high marginal savings rates for domestic growth. Implicit in the projections is that external flows are required to finance the investment and imports needed for a successful export-led growth strategy. In all of the above cases, the projections are based on the successful implementation of strong adjustment programs.

The improvements in export performance are striking, with the debt-to-export ratio falling substantially by 1995. The dangers to this strategy are twofold. First, the domestic adjustment may be insufficient to redirect the required resources to the export and investment sectors. Second, the external financing may fall short of what is required. Later in this paper the likelihood of the external financing requirement is assessed at some length.

The required net external long-term flows (net disbursements) are projected to rise sharply from $1 billion in 1988 to a range between $14 and

17 billion a year during 1989-95 for the highly indebted countries (table 5).

Table 5:

HICs EXTERNAL FINANCING, 1982-95 - Base Scenario

	1982	1983-86	1987	1988	1989-91	1992-95
	<----------(Annual averages in $ billion)---------->					
Current account deficit	51.3	8.7	7.9	8.2	16.0	17.0
Addition to reserves /a	-21.3	5.4	9.7	-5.5	4.0	6.0
Financing requirement	30.0	14.1	17.6	2.7	20.0	23.0
Non debt creating flows /b	7.5	4.5	5.6	5.3	6.0	7.0
Net LT flows	36.9	13.5	6.2	1.0	14.5	17.0
IBRD/IDA	1.9	2.9	2.3	1.5	3.0	1.5
Other multilateral	4.1	4.3	1.1	1.6	1.0	1.0
Bilateral	2.0	1.3	1.9	2.1	1.5	1.5
Total Official	8.0	8.5	5.3	5.2	5.5	4.0
Private /c	28.9	5.1	0.9	-4.2	9.1	12.0
Short term flows	-16.6	-6.7	7.1	-3.7	-0.5	-1.0
Net IMF	2.2	2.8	-1.3	0.1	-	-
Memo Item:						
Net flows as percent of interest payments to creditor						
Official	245	166	51	62	58	46
Private	103	19	4	2	35	37

/a Includes Statistical Discrepancy.
/b Principally foreign investment and official transfers.
/c Includes financing via arrears.

Source: Authors own calculations.

Given the identified sources of financing from the official sector, the expected contribution from commercial banks required to cover the external financing requirement, which amounted to a net outflow of $4 billion in 1988,

amounts to $9 billion a year in 1989-91 and $12 billion a year in 1992-95.

Lending on such a scale from commercial sources is fraught with uncertainty. It implies a significant increase in exposure and in the implicit capitalization of interest.3/ The implicit interest capitalization was only 19 percent in 1983-86; and net flows were only marginally positive in 1987. 4/ The projections imply interest capitalizations of 35 percent for 1989-91 and 37 percent for 1992-95, clearly large.

The external payments positions, including reserve holdings, of these countries differ considerably, as does the degree of macroeconomic or structural adjustment of their economies. For some countries (Chile, Uruguay) a return to voluntary access to private markets is within grasp if adjustment policies are sustained. For others the financing requirements from the commerical banks remain high, even under tough adjustment programs. For another group of countries exceptionally high net flows are required from both commercial banks and official creditors. And a few need heavy support from official creditors.

An examination of the projections for individual countries (that underlie the aggregate projections in table 5) show that the 17 highly

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/3 A measure of net transfer, implicit interest capitalization is the ratio of net lending by a creditor (say, private banks) to the interest payments due to it in any period.

/4 The aggregate figure masks large differences. Through concerted lending packages, generally supported by Fund arrangements, certain countries (Argentina, Brazil, Chile) were able to obtain increases in commercial bank exposure, but others suffered a withdrawal of commercial bank lending.

indebted countries can be divided roughly into three categories. Four countries that account for 10 percent of total highly indebted country debt require external financing over the period to 1995 that is modest in absolute terms or in light of recent history; for these few countries a strategy of growth-oriented adjustment based mainly on largely voluntary new-money packages is unlikely to be constrained by the external financing availability. Five more countries account for 35 percent of total highly indebted country debt that is large in absolute terms or in light of recent history and require external financial flows from official or private sources. The final category has holders of over half of total highly indebted country debt. They face a heavy financing requirement, in all cases except one from the private sector; the exception is the Philippines, which has the option of an officially sponsored "Marshall Aid."

15. For several highly indebted countries, especially ones that are not major debtors, the limits of the debt strategy prevailing in 1988 were clear to the market, making it extremely difficult to arrange financing packages. When financing packages have been negotiated, they have required greatly increased participation by official creditors. For several of these countries prolonged interest arrears have become a large source of financing from commercial banks. The forced burden sharing by banks in new lending has meant a shift toward a unilateral approach--hindering other (trade-related) flows and rising costs and uncertainties.

The Low Scenario

Growth in the industrial world in 1988 and thus far in 1989 has exceeded initial forecasts, with the United States, Germany, and Japan in particular experiencing a strong rise in domestic demand. But there is some risk of a marked slowdown in 1990 and 1991, to less than the 2.75 percent of GDP growth assumption. Such a temporary slowdown would, besides lowering the demand for imports from the highly indebted countries, mean less improvement in the highly indebted countries terms of trade than that projected in the base scenario. This slowdown is triggered by an officially induced rise in nominal and real interest rates of two percentage points compared to base case projections on the assumption that, as in early 1989, authorities react to accelerated inflation. This rise in interest rates would not only raise the cost of the highly indebted countries' floating rate debt. It would also--through reduced inventories and a fall-off in domestic demand in industrial countries--dampen the highly indebted countries' growth and tend to soften their terms of trade. In the simulations in table 6 it is assumed that growth in highly indebted countries' export volumes is dampened by two percentage points in 1989 and one percentage point in 1990 and that their terms of trade worsen by two percentage points in 1989-90. These adverse shocks are temporary, recovering to the parameters in the base scenario in 1992.

Table 6:

Deterioration in highly indebted countries external financing 1989-95 caused by a weaker external environment

	1989-91	1992-95
	(Annual averages in $ billions)	
Change in current account balance (- =weakening)	-12	-8
Change in net flows (+ = increase)	8	6
Official	2	2
Private	6	4
Memo Items:		
Total net flows as percent of interest payments to creditors		
Official	75	66
Private	55	66

Source: Author's own calculations.

This scenario shows how much the financing requirements of the highly indebted countries would increase. The net annual flows required rise to $30 billion for 1989-91 and $24 billion for 1992-95 (tables 5 and 6). Even on the assumptions that the multilateral and official lenders step up their lending, that the IBRD lends amounts equivalent to the maximum exposure permitted, and that other official lenders greatly raise the amounts extended over the base case, the contributions of the private sector would have to be greatly enlarged. The required net flows between 1989 and 1995 would amount to high rates of interest capitalization by banks. In light of both recent history and the current lending attitudes of the commercial banks, such financing are large.

None of the 17 highly indebted countries is likely to obtain the

additional external financing required if there is a 1989-90 recession. Brazil's new money requirements would increase by $3.5 billion a year during 1989-91, with interest capitalization of more than 50 percent overall and about 80 percent from private sources. Chile would require commercial-bank interest capitalization of about 70 percent. Mexico is perhaps a little more robust but its commercial-bank interest capitalization would still be about 40 percent. Morocco and Nigeria would need extremely heavy "new money" support in 1989-91.

PROSPECTS FOR FINANCING

Private Direct Investment

Private direct investment flows to the highly indebted countries have been slowing significantly since the beginning of the decade. But because of higher growth, better policies, an improved investment climate, and the sometimes strong incentives of debt-equity conversion programs, this trend may be reversed. These flows could recover strongly if countries implement programs that improve incentives to the private sector, liberalize trade and investment regimes, privatize public activities and reform and develop financial markets. Such reforms are central to the objectives of World Bank assistance, and the expansion of this assistance beyond levels currently planned can have favorable effects on the flow of private equity capital as well. At a minimum, it would seem reasonable to expect net direct investment flows of $4-5 billion a year (including debt-equity conversions) over the next few years. The same policy measures--with higher growth rates and specific

steps to encourage capital repatriation--should also facilitate a return of residents' hcldings abroad, or at least reduce the capital outflow from these countries, now about $9 billion a year.

Net Official Transfers

Net official transfers (including bilateral aid) to the highly indebted countries have averaged $1-2 billion a year and seem likely to be sustained at this level. Except for Bolivia (and perhaps Nigeria, Jamaica, Philippines and Costa Rica) there is little possibility that official aid flows to the 17 highly indebted countries as a group will be stepped up. The continuing budget deficits in industrial countries, the growing attention to Sub-Saharan African countries, and the relatively high level of per capita income in HICs make it difficult to expect any significant change in the attitude of official donors.

Bilateral lending

Bilateral net lending to the highly indebted countries, including export credits and mixed credits, has also averaged about $2 billion a year. Although there will be some variation in the availability of these credits, depending on the country situation and the political and strategic attractiveness to creditor governments, the aggregate sums are unlikely to be substantially higher than before. The net flows from export credit agencies have been disappointing in recent years--reflecting their difficult financial situations and the decline in borrowing countries' demand for imported capital

goods and other imports. Net new lending from these agencies has picked up somewhat, but more net flows from them in the next few years will be needed, as well as further financial relief through rescheduling and refinancing of interest. 5/

The exception to this pattern is Japan, which has been playing a prominent role. The recent actions by Japan's EXIM Bank to make large sums of untied funds available suggest the way in which the lending policies of export credit agencies should be adapted to suit the highly indebted countries' special circumstances. A combination of some increase in Official Development Assistance (ODA) and untied loans by the EXIM Bank of Japan may boost Japan's net lending to the highly indebted countries as much as $1 billion a year in the near term. But the reallocation of concessional lending to Sub-Saharan Africa and export credits to more creditworthy countries in Asia by other bilateral creditors may offset some of these gains. It is therefore safe to assume an annual net inflow of $1.5 billion from bilateral sources.

Multilateral Lending

During 1986-88, the share of the World Bank and the other multilateral development banks (MDBs) was 50 percent of total medium- and long-term flows, up from roughly 12 percent in 1980-82. If adjustment programs and economic performance develop as assumed, net flows from the IBRD

/5 Some $61 billion in debt relief was provided by Paris Club members to developing countries during 1983-87, compared with only $19 billion in 1976-82.

to the highly indebted countries can be expected to be about $3 billion a year over the next five years. A further $1 billion in net flows is likely to be available to these countries from the other Multilateral Development Banks (MDBs) at a minimum.

Commercial Banks

Commercial banks continue to lend to a handful of creditworthy borrowers (mainly in Asia), and some concerted loans are still arranged for such highly indebted countries as Brazil and Mexico. But loan charge-offs, debt conversions, swaps, buybacks, and sales have all contributed to the declining bank claims on highly indebted countries. An estimated $12.3 billion of commercial bank debt was taken off the books in the first half of 1988 alone, and the process is gaining momentum. This outcome is a major ground for pessimism about securing adequate net flows from commercial banks. It is not likely that the commercial banks' attitudes toward the indebted countries will be reversed soon. True, there will be reschedulings of principal, reduction in spreads and fees, and some concerted new-money packages, mainly to finance retroactive interest arrears.6/ But no significant new flows for balance-of-payments support are likely before 1995.

/6 Since the inception of the debt crisis, commercial banks have restructured about $300 billion in outstanding principal; they have assembled $40 billion of new-money packages and have arranged special short-term credit lines on the order of $36 billion. The figures for new financing from commercial sources in individual country situations through new-money packages do not take account of the outflows to commercial creditors in some countries. Hence, the total new money that must be raised in the market could be somewhat larger than the aggregate net financing requirements.

Constraints on Action

Debtor Adjustment Efforts

The highly indebted countries and their creditors disagree about the nature, extent, and outcome of adjustment efforts. Most creditors believe that the economic plight of the highly indebted countries has much to do with their weak commitment to reforms and with their policy slippages. The highly indebted countries have found it easier to cut investment than to tax or reduce the consumption of powerful high-income groups. The stop-go cycle of economic policies has also eroded the credibility of adjustment policies. But political leaders of the debtor countries, particularly in the new democracies, argue that a decade of continuous decline in per capita income and consumption has generated enormous social and political tensions and stretched the feasibility of these reforms to the maximum. Further reforms to pay off their debts to foreigners--reforms that impose even greater sacrifice on the population--will pose real constraints. Even in the best of circumstances, structural reforms meet formidable political obstacles across the board.

The political problem is that the costs of adjustment are immediate while the diffuse benefits materialize only gradually, far beyond the horizon of political leaders. George Schultz, when U.S. Secretary of State, observed: "If the immediate visible impact of changes in economic policy is hardship at home to keep up service on the debt, then that debt service can

have the effect of a marginal tax on economic reform. Any effort taxed at 100 percent, or at only excessively high rates will be discouraged and become politically difficult to sustain (U.S. Department of State [1988]).

Is it feasible to achieve some minimal acceptable growth in output and consumption and simultaneously improve creditworthiness? Most of the highly indebted countries cannot restore creditworthiness or gain access to capital markets even with strong adjustment policies. Moreover, the sharp cuts in investment, maintenance expenditure, and imported inputs disrupt the supply responses to better relative prices and make output gains--normally assumed as a result of successful adjustment program--difficult. Another problem is that, in assuming private-sector debt, governments have had to increase their budgetary outlays on interest payments. Financing the growing public deficits by internal borrowing or expansion of money supply has exacerbated the inflationary pressures, generated high real domestic interest rates, and added to the interest bill.

External Environment

The ability of highly indebted countries to grow out of debt also depends on the markets for their main export products. The major debtors increased the volume of their exports substantially since 1982, but terms-of-trade losses eroded the dollar gains. The value of their exports in nominal terms remains unchanged--at $150 billion a year.

The GDP growth rates of the G-7 countries have been reasonably high,

but the spillover to the highly indebted countries has been modest. The situation may get worse. Instead of averaging 3 percent or more, the major industrial economies are expected to grow at 2.5 percent annually for some time. And if the United States is serious about reducing its huge trade deficit, the chances of its taking a large increase in exports from the highly indebted countries are slim. Nor is it obvious that Japan and Germany, always reluctant to stimulate and open their economies, will absorb substantially more exports from the highly indebted countries. Their combined GDP exceeds the U.S. GDP by more than 60 percent, but they absorb far fewer exports of manufactured goods from Latin America. Another potent threat to the highly indebted countries is the growing market share of the newly industrializing economies in Asia.

The price prospects of debtor countries' major commodities are also unpromising. Real prices for most primary commodities will remain depressed because of structural and cyclical demand factors. And the heavy subsidies the industrial countries give to their relatively high-cost producers will continue to depress basic food prices.

Another uncertainty is the movement of real interest rates, which remain high. Almost two-thirds of the highly indebted countries' debt is tied to variable interest rates, opening them to interest rate shocks. Every percentage point rise will add $3.5 billion to their debt servicing, creating larger demand for new capital inflows or debt reduction. The policies of the United States and its major trading partners will determine the interest rate, exchange rates, and the debt servicing capacity of the highly indebted

countries. For example, a fall of the U.S. dollar could drive interest rates way up and push the U.S. economy into a recession.

A combination of slower OECD growth, collapsing commodity prices, and rising real interest rates could wreck the highly indebted countries' economic prospects.

Commercial Finance

The total likely to be available from all known and identified sources of finance--private investment, official transfers, bilateral, multilateral, and export credits--will not exceed $6-7 billion a year. The financing gap during 1989-95 remains about $9-10 billion. Private commercial banks traditionally supplied the bulk of financing to the highly indebted countries, but the constraints on their lending have intensified in recent years for five reasons.

First, skepticism is growing about the near-term prospects for improved creditworthiness in the debtor countries. Bankers know that restoring creditworthiness will be a long and uneven process. They know, too, that the domestic political difficulties of implementing reform programs reduce the likelihood of success. To make matters worse, interest arrears are increasing, some because of unilateral moratoria on debt service payments.

Second, banks face intensified pressures, both regulatory and competitive, to strengthen their balance sheets. The regulatory authorities

in many industrial countries are adopting more conservative guidelines, presenting banks with stricter and more comprehensive capital requirements. As a result, they are realigning their strategies to strengthen their capital base, restrain asset growth, focus on fee-based activities, cut exposure to developing countries, and improve profitability.

Third, the effect of depressed secondary market prices for developing country loans has damaged the share prices of banks that have large exposures. Prices in the secondary market suggest a reserve level of about 50 percent. If the reserves are increased that high, the regulatory capital position of the U.S. money-center banks will get worse, probably costing them substantial losses. Moreover, banks face the prospect of additional provisioning on new lending, making participation in concerted new money packages expensive and at best marginally profitable. Inter-country differences make matters worse. Even though the loan-loss provisions by the U.S. banks appear to be in line with other major banking systems, the burden and risk for the U.S. banks is greater. They have a higher concentration of lending to highly indebted countries and much weaker capitalization. Banks in Japan and the United States, unlike their European counterparts, receive no major tax benefits for creating reserves. The depreciation of the U.S. dollar has also reduced the relative exposure of non-U.S. banks in developing countries. The reluctance of U.S. money-center banks and Japanese banks to increase their exposure to highly indebted countries is thus understandable.

Fourth, the long-term business interests of commercial banks are once again diverging. The universal (or critical-mass) participation in concerted

lending--the modus operandi in the early years of the debt crisis--was made possible by the banks' shared interest in protecting the international financial system and in buying time to reduce exposures. Except for the large international banks, this phase has ended, and the underlying differences in exposures and business strategies are determining the decisions of individual banks to participate in lending new money. Many regional and small-exposure banks are redirecting their lending to traditional domestic and trade financing. Even among the larger banks, there are differences in financial interests and objectives. Those with multinational corporate clients--and, in some cases, with significant domestic banking operations in developing countries--can be expected to maintain direct interest in improving the liquidity of specific debtor countries. But other banks are trying to leave the debt-restructuring process, even at the cost of significant write-downs.

Fifth, sustaining the concerted new-money process will require adaptations and new approaches whose success is as yet uncertain. Restructuring agreements have consolidated most of (formerly independent) debt obligations and established a uniform legal standing for all commercial creditors' claims. The sharing clauses in these agreements make it possible, however, for some creditors to collect full interest due on their outstanding claims without contributing to the fresh-money loans that help provide the resources to pay that interest. This free rider (or recalcitrant bank) problem has become much greater as the new-money participation rates fall./7

/7 In Colombia, for instance, only 112 of about 175 creditor banks participated in the January 1988 new-money facility, which had to be reduced to complete the deal.

As a result, the ability and willingness of the larger banks to continue to lend is subject to additional stress. Exit instruments thus far have not sustained the burden sharing concept that was part of the original restructuring, for reasons that have perhaps less to do with the design of the instrument than with the extremely complex legal issues surrounding attempts to close off the free-rider opportunity.

It will thus be extremely difficult--perhaps impossible--to generate aggregate net flows for the highly indebted countries in the needed amounts exclusively through the concerted new-money approach. Banks still hold about two-thirds of total medium- and long-term claims on the highly indebted countries, but the pressures not to lend will grow, forcing selectivity and strong reluctance to accept exposure increases that in other circumstances might look reasonable (2 to 3 percent on average, roughly a quarter to a third of interest due). The number of banks participating in new-money packages is likely to narrow further, as is the number of countries for which such financing can be arranged. Banks will likely concentrate any new exposure on countries where their financial and long-term business interests are substantial and where the prospects for a successful workout are reasonably good. Smaller countries, particularly those with weak adjustment programs, will continue to find it difficult to arrange concerted support (though not necessarily continued restructurings of principal).

SCOPE FOR ACTION

The constraints to mobilizing adequate flows of new money, especially from the commercial banks, are likely to remain strong. Part of the reason for this is that when a systemic payments problem arises, markets tend to experience "revulsion," and credit volumes become paralyzed by a neighborhood problem--good and bad debtors are lumped together (Eichengreen 1989). Colombia has not had a debt problem as such in the 1980s, but its efforts to secure truly voluntary syndicated loans has nevertheless been severely frustrated.

If the net flows from commercial banks are unlikely to rise significantly, what other means would meet the financing requirements of this group of countries? There is no clear-cut or simple answer. Needless to say, the debtor countries themselves have to continue taking primary responsibility for their fate through further adjustment, however painful and politically difficult it may be in the short term. The more flexible and responsive their economies are, the more resilient they become in facing unexpected economic shocks and in improving their creditworthiness. Favorable economic policies and good economic management will attract both new project and trade financing, multilateral lending, export credits, and direct equity investment. So, sound policies are essential for capital inflows and for other alternative financing. The other possible means for filling the financing gaps include reduction in the stock of debt or debt servicing followed by reflows of flight capital. And in cases where the debt reduction achieved is not sufficient to fill in the gap and the country is pursuing

sound adjustment policies, consensual or sanctioned accumulation of interest arrears could supplement.

Debt Reduction

Why is debt reduction then a preferred option for the highly indebted countries to fill in their external financing requirements in pursuit of a reasonable level of growth? The net negative transfers have lowered the investment ratios, which have reduced output growth and exports and in turn their capacity to fully service their debt. The reversal of the net negative transfers can be achieved by increasing new flows of money but as we have examined earlier the probability of new money flows to highly indebted countries in the next five years or so, especially from the commercial banks, is very limited. The other option is to reduce debt or debt servicing. The general argument in favor of debt reduction rather than new money is that many debtor countries have been unable to return to growth in the presence of very large debts. One reason for the persistence of slow growth is that debt overhang acts as a tax on increases in current and future income. If for example, a country is able to increase its exports as a result of policy reforms or more investment, a large share of the benefits is likely to accrue to creditors rather than to the country itself. This will depress the returns to the country from fixed capital investment and thereby weaken the incentive to invest even if finance is available. By reducing the creditors' share of the benefits from the adoption of adjustment policies and by reducing the uncertainty surrounding the sustainability of adjustment, debt reduction encourages investment and the incentive to implement better policies which, in

turn, boost exports and debt servicing capacity. In this case, debt reduction could make both debtors and creditors better off.

The IMF (1989) has found supporting empirical evidence for the debt-overhang hypothesis. When external financial flows dried up after 1981, debtors were forced to run trade surpluses in order to service their debt. Adjustment in the trade balance can be achieved by reducing the consumption-output ratio or the investment-output ratio. In the highly indebted countries, the consumption-output ratio has not only failed to decline in proportion to the investment-output ratio but has actually risen on average between 1982-87.

The second piece of evidence to the existence of these disincentives is the contrast in the behavior of investment-output ratio between groups of countries with and without recent debt-servicing problems. For countries with debt-servicing problems, the average investment ratio fell from about 25 percent in 1980-81 to about 18.5 percent in 1987. By contrast, the group of countries without debt-servicing problems experienced very little change in its investment-output ratio, from about 28 percent in 1980-81 to 27.25 percent in 1987.

A third indication of this phenomenon is provided by changes in the composition of investment in the indebted countries. If debt service depends on overall macroeconomic performance, disincentives should apply to both the private and public sectors. Empirical estimates of disaggregated behavior of investment in a sample of debt-problem countries show that both public and

private investment ratios drop from 1981 to 1984.

The cumulative thrust of the evidence reviewed in the IMF study, that is the behavior of the consumption-output ratio in the debt problem countries, the contrast between the investment-output ratio in these countries and in countries without debt problems, and the sectoral evolution of investment between the public and private sectors are all broadly consistent with the presence of debt-overhang disincentives.

Debt-reduction measures can be divided in several categories: (a) exchange of foreign debt against domestic asset (debt-equity conversion); (b) exchange of foreign debt against another foreign asset at a discount; (c) debt buybacks, and (d) debt-servicing reduction through reduced interest rates.

In the first approach, the original lender (or another party) has bought the debt at a discount on a secondary market, takes a loan to the country, and obtains in exchange local currency for the full face value of the official exchange rate. This local currency is used for purchase of local equity, relending, and so on. The advantage for lenders is that they find a use for their loans at a face value while the advantage to the borrower is reduced debt. But if the assets acquired by the creditor are private and the debt is held by the government, which is the case in most highly indebted countries, this type of conversion contributes to accelerating inflation and higher real interest rates if the government is already facing fiscal deficits. In that case, to redeem the foreign debt, the government increases its internal borrowing or prints money.

The exchange of debt for other debt instruments at a discount such as bonds and exit bonds require that the new instrument is a more secured asset, and the probability of the borrower fully servicing this asset is larger than the old debt. This usually requires that the new asset is backed by collateral for the principal or a guarantee for interest or both. To purchase the collateral the country must have excess reserves that it can use or borrow, or obtain the resources from other sources. In the Mexican deal, although Mexico provided collateral for the ultimate repayment of principal (zero coupon U.S. bonds it had bought for cash) the outcome was disappointing since the additional value placed by creditors on the new instrument did not exceed the present value of the collateral.

In the third type of operation, a country buys back its debt at a discount for cash. Bolivia and Chile are two such examples. Countries in debt difficulties rarely have much cash lying about: the Bolivian operation had to be financed by aid agencies. Chile was able to accumulate some reserves in the Copper Stabilization Fund due to unanticipated increases in price of copper. In both cases, there were exceptional circumstances that facilitated the debt buybacks. In the literature, pursuasive arguments support this.

The fourth type of debt reduction, that is reduced interest rates on exisiting debt instruments, has not so far been put into practice. The reduced interest rate option is attractive from the debtors' viewpoint as they receive a substantial relief in cash flow. As the reduced interest rate is

tied to economic performance, the fear of moral hazard is also, to a large extent, neutralized. A case-by-case approach to interest rate reduction negotiated in the framework of an agreed structural adjustment program can make a significant dent if the accounting and tax rules are modified to strengthen the incentives for the commercial banks.

The present tax and accounting rules do not provide any incentive for the banks to agree to reduction in interest rates. A variant of reduced interest rates that is attractive is analogous to equity warrant attached to bond issues. If the country's major export commodities register an upward swing relative to the threshold, the creditors participate in the gains proportionately and the interest rate reduction granted earlier is brought closer to the market rate in accordance with the country's payment capacity.

It has also been suggested that reflows of flight capital the highly indebted countries can also fill their external financing gap. Estimates of flight capital vary greatly but the pool may be as large as $300 billion (Morgan Guaranty 1988). The conditions under which flight capital find its way back are not necessarily conducive to the financial stability of the country. Those willing to bring back their flight capital require higher risk premiums which result in high economy-wide real interest rates. They choose to keep the assets in a highly liquid form and do not always invest in the expansion of productive capacity. And at the first possible indication of political or economic uncertainty, these financial assets leave the shores of the country, accentuating financial destabilization. While foreign debt is guaranteed by the debtor's government and thus safe from default risk,

domestic investments by residents face expropriation risk (Khan and Haque 1985). This gives developing-country residents further incentives to place their funds in riskless savings accounts abroad, and it gives foreigners a comparative advantage in lending for domestic investment. If this expropriation asymmetry persists and uncertain economic policy environment persists there is little hope for substantial reflows of flight capital in the near term. Unless the country is able to eliminate debt overhang, reduce economic uncertainty, and stabilize the economic environment there is very little hope for significant inflows of flight capital.

This finally leads to the question that has been the stumbling block for the success of voluntary debt reduction, that is free-riding banks that do not wish to participate in voluntary debt reduction hoping others will. These banks hold out expecting that the value of their claims will be strengthened and pushed back to par value by the exit of other creditors. The regulatory authorities can play an important role in this regard by treating the nonparticipants differentially and harshly compared to those participating in the debt reduction. The key to the future direction of debt reduction therefore lies in the way the sticks and carrots are allocated.

The Brady Initiative

The Brady Initiative, announced in March 1989, makes a significant departure from the existing debt strategy by allowing the use of financial resources of the International Financial Institutions (IFIs), that is, the World Bank and the IMF in support of debt and debt-service reduction in

countries pursuing strong adjustment policies. Although this is a step in the right direction, the voluntary choice given to the commercial banks for participation under the existing ground rules and the limited resources likely to be available from the IFIs have raised some skepticism as to whether the size of debt reduction would be sufficient to offset the debt overhang. The voluntary market-based case-by-case approach is an adequate response if the tax, regulatory, and accounting rules provide incentives to commercial banks for participation and penalties for free-riders or nonparticipants.

The existing rules and precedents were set to facilitate new-money flows. Debt reduction, beyond a certain limited scale, would impose additional financial costs to the commercial banks. The credit enhancement or the resources for debt buybacks provided by IFIs would not be sufficient to make a significant dent in larger debtor countries. Thus the Brady Initiative may be able to assist the smaller countries, but it appears that the expectations that have been aroused about its impact in the larger countries are at present exaggerated.

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